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PREVIEW

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Caniglia v. Strom

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CONTENTS

MARCH 22

TAKINGS CLAUSE

Cedar Point Nursery and Fowler Packing Co. v. Hassid **3**

MARCH 23

TRIBAL JURISDICTION

United States v. Cooley **7**

MARCH 24

FOURTH AMENDMENT

Caniglia v. Strom **11**

MARCH 29

SECURITIES CLASS LITIGATION

Goldman Sachs Group, Inc., et al. v.
Arkansas Teacher Retirement System, et al. **17**

MARCH 30

CLASS ACTION LITIGATION

TransUnion LLC v. Ramirez **24**

MARCH 31

SPORTS LAW

NCAA v. Alston and *AAC v. Alston* **31**

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SECURITIES CLASS LITIGATION

Is the Rebuttable Fraud-on-the-Market Presumption in Securities Class Litigation Actually Irrebuttable?

CASE AT A GLANCE

This appeal from the Second Circuit addresses two issues relating to the "fraud-on-the-market" presumption of classwide reliance available to plaintiffs in securities class action litigation. First, the Court will assess the way in which courts should address a defendant's claim that the generic nature of alleged misstatements fails to impact a security's price. Second, the Court will determine the parties' relative burdens of production and persuasion in seeking to use or rebut the presumption.

Goldman Sachs Group, Inc., et al. v. Arkansas Teacher Retirement System, et al.
Docket No. 20-222

Argument Date: **March 29, 2021** From: **The Second Circuit**

by Linda S. Mullenix
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Issues

How does a court evaluate a defendant's attempt to rebut the fraud-on-the-market presumption of classwide reliance in securities class litigation by pointing to the generic nature of alleged misstatements to show that the statements had no impact on a security's price?

Does a defendant seeking to rebut the fraud-on-the-market presumption carry only a burden of production, but not the ultimate burden of persuasion on the question?

Facts

In 2010, the Arkansas Teacher Retirement System as a major institutional investor in various securities sued the Goldman Sachs Group, Inc., and three of its former executives in the Southern District of New York. The plaintiffs alleged that the defendants had violated the Securities and Exchange Act (SEC) of 1934 and SEC Rule 10(b)-5. 15 U.S.C. 78j(b) and 17 C.F.R. 240.10b-5(b). These provisions forbid the use of deceptive, misleading, or untrue statements of materials facts in the purchase or sale of any security.

The plaintiffs alleged that Goldman made material misstatements concerning its aspirational goals as well as the risks of conflicts of interest that negatively impacted the price of four collateralized debt obligation securities (CDOs) it sold in 2000 and 2007. Examples of Goldman's aspirational business principles stated in annual reports since 1999 included statements such as "Our clients' interests always come first," and "Integrity and honesty are at the heart of our business." Goldman's annual SEC filings since 2003 included warnings about conflicts of interest, such as, "As we have expanded the scope of our businesses and our client base, we increasingly have to address potential conflicts of interest," and "Conflicts of interest are increasing and a failure to appropriately identify and deal with conflicts of interest could adversely affect our business."

The plaintiffs complained that Goldman's statements were fraudulent because Goldman had conflicts of interest in the CDOs, which it hid from various investors. The plaintiffs' complaint detailed how those statements

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were false and misleading. The plaintiffs contended that Goldman's statements omitted the fact that it had structured transactions in the CDOs to benefit Goldman and certain of its clients to the detriment of other investors. In addition, the plaintiffs contended that three corrective disclosures Goldman issued between April and June 2010 revealed to the market the falsity of Goldman's statements and exposed its conflicts of interest. The plaintiffs alleged that the three corrective disclosures resulted in stock price decreases that could be attributed to the challenged statements. Finally, viewing this history of Goldman's market behavior, the plaintiffs alleged a claim of "inflation-maintenance." The plaintiffs argued that Goldman managed to artificially maintain its stock price above the value it would have had if the market was aware of the truth of Goldman's actual management of its conflict of interest.

The plaintiffs moved to certify a class action on behalf of Goldman stock purchasers between February 2007 and June 2010. In support of class certification under Rule 23(b)(3), the plaintiffs invoked the fraud-on-the-market presumption of classwide reliance on Goldman's statements, a presumption the Court recognized in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988)(*Basic* presumption). The plaintiffs also relied on the inflation-maintenance contending that a misrepresentation can have a price impact even if it does not cause the stock price to increase by preventing an already inflated stock price from decreasing.

Goldman responded to the plaintiff's class certification effort by seeking to rebut the *Basic* presumption with evidence that the alleged misstatements had no price impact. The court refused to consider Goldman's expert witness testimony. The defendants argued that such generic, general, and aspirational statements could not have affected the stock prices. The defendants further argued that the statements were relevant in assessing whether they had impacted the stock price, which might overlap with the merits of the materiality of the statements. The district court certified the class action, holding that the defendant's evidence related solely to the statements' materiality and not price impact. The court concluded that the defendants failed to completely disprove price impact.

The Second Circuit vacated the court's certification order and remanded the case. The appellate court agreed with Goldman that evidence relating to price impact overlapped with materiality, but the statements could be considered in evaluating price impact. However, the district court had failed to apply a preponderance-of-the-evidence standard to determine whether the defendant had rebutted the *Basic* presumption. The Second Circuit also held that the district court erred in refusing to consider Goldman's expert report.

The appellate court also rejected Goldman's argument that, to rebut the presumption, a defendant bears only the production of evidence burden. The court ruled that the *Basic* presumption had modified the default Evidence Rule 301 regarding presumptions, holding that defendants carry both the burden of production as well as the ultimate burden of persuasion.

On remand, the defendants renewed their argument that they had rebutted the *Basic* presumption because the alleged statements had no price impact. Goldman submitted a supplemental report to its original expert and offered an additional expert report on price impact. The plaintiffs' countered with their own sole expert testimony. The court certified the class again, holding that the defendants had failed to rebut the *Basic* presumption by a preponderance of the evidence. The court found that the statistical evidence that Goldman's expert offered was unreliable. The court concluded that the defendants' evidence was insufficient to sever the link between its first corrective disclosure and the stock's price decline.

The defendants appealed for a second time. In a divided opinion, the Second Circuit upheld the class certification and concluded that the defendants had failed to rebut the *Basic* presumption. The court rejected Goldman's contention that inflation-maintenance cases cannot be certified without proof that the misstatements were material. Instead, the majority held that the inflation-maintenance theory required a court to find that a corrective statement caused a reduction in the stock's price; if so, a court could infer that the stock price was inflated by the amount of the reduction. The court held that the defendants' price-impact argument was an impermissible backdoor attempt to have the court consider materiality, which the court contended is forbidden at class certification. The court further refused to consider the generic nature of Goldman's statements, rejecting the argument that the generic nature had not impacted the stock price.

The Second Circuit distinguished between improper reliance on the standard for determining materiality, as opposed to a court's permissible reliance on *evidence* that

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might overlap with materiality. Turning to the district court's assessment of competing expert evidence, the Second Circuit found no error in the court's assessment of the competing experts. Finally, the majority concluded that the defendants failed to rebut the *Basic* presumption by a preponderance of the evidence. The court indicated that the defendants carried a very heavy burden of production and persuasion to rebut the presumption.

Judge Richard J. Sullivan dissented, noting that the majority's conclusion turned the *Basic* presumption on its head. He contended that the majority's approach rendered the *Basic* presumption irrebuttable, allowing for class certification in every case. Based on the evidence of Goldman's two experts, Judge Sullivan concluded that this evidence had disproven price impact. Judge Sullivan suggested that the generic nature of the defendants' statements explained the absence of a price decline in response to news reports of the alleged conflicts.

Case Analysis

For the fourth time in a decade, the Court will turn its attention to the *Basic* fraud-on-the-market presumption in shareholder security class litigation. The Court previously addressed the presumption in *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804 (2011) (*Halliburton* I), *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 568 U.S. 455 (2013) (*Amgen*), and *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014) (*Halliburton II*).

Securities fraud class actions are a specialized type of fraud litigation governed by Section 10(b) of the Securities and Exchange Act of 1934 and SEC Rule 10b-5. 15 U.S.C. 78j(b) and 17 C.F.R. 240.10b-5(b). These provisions prohibit fraud, deception, or untrue statements of material fact in the purchase or sale of securities. When a plaintiff individually pursues an ordinary common law fraud claim, the plaintiff must prove that he knew of an alleged fraudulent or misleading statement and relied on that statement to the claimant's detriment. In securities class litigation, however, courts have created an exception to this individual reliance requirement.

To certify a class action under Federal Rule of Civil Procedure 23(b)(3) for alleged violations of Section 10(b) and Rule 10b-5, plaintiffs must demonstrate that common issues of law or fact predominate over individual issues. In 1988 in *Basic, Inc. v. Levinson*, the Court announced a rebuttable presumption that enables class certification in securities class actions. Security purchasers may rely on the market integrity in stock pricing.

This fraud-on-the-market presumption enables class plaintiffs to submit proof of an efficient market of reliance in lieu of individual proof that would undermine the predominance requirement. To invoke the presumption of reliance, plaintiffs must establish that (1) the defendant made public, material misrepresentations, (2) the defendant's shares were traded in an efficient market, and (3) the plaintiffs traded shares between the time the misrepresentations were made and the time the truth was revealed.

After plaintiffs show market efficiency and publicity, defendants must try to disprove price impact. A defendant may then rebut the presumption by showing that the misrepresentation in fact did not lead to a price distortion. The parties generally dispute these issues through expert witness testimony known as "event studies" of misstatements. A defendant may rebut the presumption by refuting the elements (such as market efficiency) or by making "[a]ny showing that severs the link between the alleged misrepresentation and either the price received or paid by the plaintiff, or his decision to trade at a fair market price."

If a defendant successfully rebuts the reliance presumption, then the causal connection between the misrepresentation and the plaintiffs' reliance is broken. The plaintiffs must then respond with sufficient evidence to reestablish the presumption. If the plaintiffs cannot, they would have to establish reliance on a plaintiff-by-plaintiff basis. If plaintiffs cannot demonstrate they are entitled to a reliance presumption or otherwise show that common issues predominate, a court may not certify a class action under Rule 23.

In 2011 in *Halliburton I*, Halliburton asked the Court to tighten class certification requirements when plaintiffs invoked the fraud-on-the-market presumption. Halliburton contended that plaintiffs must prove "loss causation" as a predicate to application of the *Basic* presumption. Chief Justice John Roberts, writing for a unanimous Court, rejected Halliburton's suggestion to tighten plaintiffs' burden at class certification. The Court simply held that plaintiffs in a Rule 10b-5 securities action did not need to prove loss causation to obtain class certification. The Court indicated that a rule requiring proof of loss causation as a precondition to class certification contravened *Basic*'s fundamental premise: that investors presumptively rely on misrepresentations so long as they were reflected in the market price at the time of their transaction.

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In 2013 in *Amgen*, the Court split 6–3 in addressing the issue whether plaintiffs needed to show the materiality of defendants' alleged misstatements to apply the presumption. Justice Ruth Bader Ginsburg, writing for the majority, held that plaintiffs do not carry a burden to prove the materiality of alleged fraudulent statements to take advantage of the fraud-on-the-market presumption. The majority concluded that while the plaintiffs would need to prove the materiality at summary judgment or trial to prevail on the merits, such proof was not a prerequisite to class certification. Rule 23(b)(3) required a showing that common questions predominated, not that those questions would be answered in the class's favor on the merits.

In addition, the majority reaffirmed general principles of class certification jurisprudence. Citing *Wal-Mart Stores, Inc. v. Dukes*, the Court restated that a court's class certification analysis must be rigorous and may entail some overlap with the merits of the plaintiff's underlying claims. 564 U.S. 338 (2011). The Court acknowledged that merits questions may be considered only to the extent that they are relevant to determining whether a plaintiff can satisfy the Rule 23 prerequisites for class certification. The Court rejected, however, Amgen's policy arguments concerning the *in terrorem* effects and settlement pressure of class certification decisions as a reason for imposing heightened burdens on plaintiffs.

In 2014 in *Halliburton II*, the Court revisited the issue concerning a defendant's showing to rebut the *Basic* presumption and declined to artificially limit the evidence defendants may use to rebut the presumption. Thus, a court must consider any evidence a defendant proffers to demonstrate that an alleged misrepresentation did not have a price impact. The Court held that "in absence of price impact, *Basic*'s fraud-on-the-market theory and presumption of reliance collapse."

The Court further indicated that the price-impact inquiry differed from the materiality question and rejected the argument that *Amgen* prohibited defendants from introducing evidence of the absence of price impact, based on the theory that such evidence was relevant to a merits issue. Instead, a court must permit defendants to seek to defeat the *Basic* presumption through direct as well as indirect price-impact evidence. Defendants may present any evidence to show that an alleged misrepresentation did not affect a stock's price, even if that evidence was relevant to a merits inquiry.

On appeal to the Supreme Court, Goldman Sachs now argues four points. First, Goldman contends that the appellate court erred in not permitting the defendant to point to the generic nature of the alleged statements to show that those statements did not have a price impact. Second, Goldman argues that the appellate court erred in holding that defendants shoulder the ultimate burden of persuasion to rebut the *Basic* presumption. Third, Goldman stresses that the appellate court's decision further limits the type of evidence a defendant can use to show the absence of a price impact, which effectively turns the *Basic* presumption into an irrebuttable presumption. And fourth, as a matter of policy, Goldman maintains that rendering the presumption as irrebuttable will have an *in terrorem* effect on defendants in securities class litigation, effectively exerting hydraulic pressure on defendants to settle the litigation without regard to the merits of the claims.

Relying heavily on the Court's *Halliburton II* decision, Goldman argues that price impact is *Basic*'s fundamental principle and the Court clearly indicated that defendants are entitled to introduce *any* evidence of the absence of price impact to rebut the *Basic* presumption. This includes pointing to the generic nature of the alleged misstatements that were the basis for the plaintiffs' claims. Discussing the nature of the generic statements, the defendants contend these statements present powerful evidence of a lack of price impact because the more vague or generic the announcement, the less likely it would move the market price of a security.

In addition, Goldman argues that consideration of the generic statements does not contravene the Court's *Amgen* holdings as the Court did not hold that a court could ignore such evidence because it might overlap with the issue of materiality. Goldman further suggests that *Halliburton II* supports this interpretation of *Amgen*, because the Court rejected the theory that *Amgen* prevented a defendant from offering evidence to show the absence of price impact.

Regarding the allocation of burdens of production and persuasion, Goldman argues that the plaintiffs hold the ultimate burden of persuasion to prove a price impact when invoking the *Basic* presumption. Citing Federal Rule of Evidence 301, Goldman contends that the burden of persuasion remains on the party who originally had it: namely, the plaintiffs. Federal Rule of Evidence 301 applies to presumptions, and there is no statute or rule shifting the burden to defendants. Indeed, no statute created the *Basic* presumption.

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Moreover, Goldman maintains that in *Halliburton I* the Court refused to artificially limit the evidence a defendant could proffer to defeat the *Basic* presumption. Even prior to *Halliburton II*, the Court acknowledged that courts determining class certification under Rule 23 might enquire into the underlying merits of the claim. *Comcast v. Behrend*, 569 U.S. 27, 35 (2013). Thus, it does not matter that a defendant seeking to defeat the *Basic* presumption offers evidence that also is relevant to the merits of the case.

Reviewing the Court's trio of *Basic* presumption cases, Goldman argues finally that the decisions compel the following conclusions: "Plaintiffs are not required to prove materiality or loss causation in order to invoke the *Basic* presumption at class certification, but the court must consider *all* evidence offered by the defense showing that the alleged misrepresentations did not actually affect the stock price."

Goldman advances various policy concerns with limiting the evidence defendants may use to rebut the presumption, as well as shifting to defendants the ultimate burden of persuasion. These rulings would effectively render the presumption irrebuttable, "imposing enormous costs on public companies and shareholders." If the plaintiffs can mount a securities class action based on generic statements that companies make all the time, then plaintiffs will always be able to find such statements with a tenuous connection to a subsequent corporate corrective disclosure. Because most securities class actions never proceed to summary judgment, the costs of discovery will exert enormous pressure on defendants to settle.

Finally, Goldman attacks the plaintiffs' inflation-maintenance theory, pointing out that, while the Court has never endorsed this theory, several appellate courts have. Goldman notes that the inflation-maintenance model has now become a plaintiffs' favored argument, asserted in some 71 percent of recent cases. Plaintiffs' use of the inflation-maintenance theory, Goldman argues, impedes defendants' ability to rebut the *Basic* presumption. It allows plaintiffs to rely on the presumption even if there is no evidence of a price impact stemming from a misstatement.

Goldman notes that more than 2,000 securities class actions have been filed since *Halliburton II* in 2014. In this universe of cases, Goldman could identify only one in which a defendant successfully rebutted the *Basic* presumption. Moreover, in the 20 district court cases since *Halliburton II* where plaintiffs invoked the inflation-maintenance theory, defendants have never once rebutted the *Basic* presumption. "However, the *Basic* presumption is supposed to work in theory, it is a mean feat to rebut it in practice."

Goldman concludes by asking the Court to apply the proper framework for rebutting the *Basic* presumption and to reverse outright the district court's class certification. Goldman thus asks the Court not to remand the case for further proceedings, giving the plaintiffs a third bite at the apple.

In response to Goldman's arguments, Arkansas Teacher Retirement System (Arkansas) contend that the Court should not even consider Goldman's arguments on appeal, because Goldman did not properly preserve certain issues and therefore had waived its rights to reconfigure the appellate review. Arkansas suggests that Goldman waived its argument that judges may freely make commonsense judgment of the price impact of general statements because it did not raise it in its Second Circuit appeal. In addition, Arkansas argues that Goldman did not preserve any challenge to the district court's assessment of the expert witness testimony and that the district court had not refused to consider evidence regarding the statements' generality. Arkansas protests that Goldman is now asking the Court to substitute its own commonsense view of the generality of the statements' impact on price.

If the Court does consider Goldman's appeal, Arkansas notes that the parties agree on several points. Thus, Arkansas suggests that the parties agree that in assessing price impact, courts may take into account the "generality" of alleged statements, which is already the Second Circuit's rule. The parties also agree that inquiries regarding price impact may overlap with materiality questions suitable for resolution on the merits. The parties disagree, however, on *how* courts should evaluate such statements. Arkansas indicates that Goldman believes that courts should rely on judges' personal, common-sense intuitions to assess whether general statements support the conclusion that those statements have no effect on security's price. The better view, according to Arkansas, is for courts to consider only the actual evidence provided by expert testimony concerning whether statements are so generalized as to have no price impact.

Arkansas strenuously argues that courts should only consider actual expert evidence on the question of price impact and should not rely on their own intuitions. Judges, Arkansas suggests, are poorly situated to intuit whether

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general statements and omissions had an impact—or zero impact—on a security's market price. Instead, qualified experts are better situated to address whether general statements did have market price impact or not. Arkansas notes that the district court received extensive submissions and expert reports and held an evidentiary hearing. Arkansas argues that the district court properly weighed and assessed the competing experts' actual evidence and found that one of the defendant's expert reports was methodologically flawed.

Turning to the issue of burdens of persuasion and proof, Arkansas argues that precedents clearly indicate that a defendant must prove the absence of price impact and that the Court's *Halliburton II* decision refused to place the burden of persuasion of price impact on plaintiffs. Arkansas notes that the defendant's burden of production is not so heavy. Thus, if the burden of persuasion were shifted to plaintiffs, the presumption of reliance would be of little value if it could be overcome so easily. As a matter of black-letter law, courts have long had the authority to adopt burden-shifting regimes to implement federal statutes. Furthermore, Arkansas contends that for more than thirty years the Court has maintained that Rule 301 does not restrict judicial authority to change the customary burdens of persuasion. Arkansas further claims that Federal Rule of Evidence 301 is inapplicable to class certification procedures.

In conclusion, Arkansas suggests that if the Court is uncertain whether Goldman waived its right to argue its commonsense approach, then the Court should vacate and remand to the Second Circuit to determine whether Goldman preserved that argument. However, if the Court agrees that judges should rarely if ever depart from the practice of considering actual expert evidence, then the Court should affirm the Second Circuit's decision. According to Arkansas, there is no basis for the Court to reverse because the Second Circuit already applied the proper rule in securities class certification cases. Arkansas points out that its litigation is now eleven years old and the parties have contested the class certification issue repeatedly during the past five years. Thus, Arkansas indicates that there is no basis for the Court to now require the parties and the courts to do this class certification all over for yet a third time.

Significance

It is possible that the Court may heed Arkansas's position that Goldman waived its argument concerning the methodology by which courts should assess a defendant's rebuttal of the *Basic* presumption, by failing to raise its contentions in its Second Circuit appeal. If so, the Court could merely vacate and remand the Second Circuit decision with instructions to ascertain whether Goldman's argument was preserved. However, the Court might take the opportunity to use the *Goldman* appeal to revisit the *Basic* presumption and the contours of how plaintiffs may invoke the presumption and defendants rebut it.

For the past decade, the securities plaintiffs' and defense bars have been engaged in a kind of guerilla warfare to preserve, impair, or kill off the *Basic* presumption of reliance. To date, the Court's liberal wing has successfully fended off repeated corporate defense attacks on the *Basic* presumption. However, with the Court's change in personnel since *Halliburton II*, it will be interesting to see whether the *Basic*'s liberal bulwark will remain invincible to this renewed attack on the doctrine.

As far back as *Halliburton I*, the Court's *Basic* dissenters had already aligned: Justices Antonin Scalia, Clarence Thomas, and Samuel Alito. These justices renewed this antipathy toward the *Basic* assumption in *Halliburton II*, where Justice Thomas, joined by Justices Scalia and Alito, minced no words: "Today we are asked to determine whether *Basic* was correctly decided. The Court suggests that it was, and that *stare decisis* demands that we preserve it. I disagree. Logic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption, and *stare decisis* cannot prop up the façade that remains. *Basic* should be overruled."

Justice Thomas explained that *Basic* should be overruled because the passage of time revealed and compounded three fundamental flaws in the "reimagined reliance requirement." First, the Court based the presumption of reliance on a questionable understanding of disputed economic theory and flawed intuitions about investor behavior. Second, *Basic*'s rebuttable presumption was at odds with the Court's subsequent Rule 23 cases, which require plaintiffs seeking class certification to "'affirmatively demonstrate'" certification requirements like the predominance of common questions, citing *Comcast Corp.* and *Wal-Mart v. Dukes*. Finally, Justice Thomas argued that *Basic*'s presumption that investors rely on the integrity of the market price was virtually irrebuttable in practice, which meant that the "essential" reliance element effectively existed in name only.

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None of the parties have raised the issue concerning the continuing viability of the *Basic* presumption and whether the Court should overrule it. If the Court determines to address the two issues raised on appeal, the Court could simply answer the very narrow question of the appropriate role of the court (the "how") in assessing whether general statements have price impact, or not. In addition, the Court could plant its flag more firmly in one camp or the other concerning whether the *Basic* presumption involves burden-shifting, or not. But the more interesting question is whether the cohort of justices who have been agitating for overruling the *Basic* presumption might seize on this appeal to do just that. It would not be the first time that the Court has gone beyond the bounds of the issues presented to use an appeal as a platform for more wholesale doctrinal revision.

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